

# THE IMPACT OF CORPORATE GOVERNANCE LEGISLATION ON THE MARKET FOR CORPORATE OWNERSHIP

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## Abstract

Over the past few years, the number of corporate scandals and failures throughout the world has escalated, prompting new legislation designed to enhance corporate governance. While the efforts to legislate corporate governance policies are designed to protect the public interest, they have altered the relationship between shareholders and management (Canada et al. 2008). Rather than be subjected to new corporate governance requirements, many companies have indicated an interest in not being traded on the various stock exchanges and have chosen to alter their corporate structure. The purpose of this study is to examine how a company's decision to shift corporate ownership and/or corporate control in the face of new corporate governance legislation and regulatory requirements can alter the traditional markets for ownership and control. In order to examine this issue, the paper first develops a typology for predicting the type of organizational restructuring that might occur. This typology incorporates factors from prior research and disentangles the market for ownership from the market for corporate control. The typology is then used as a basis for an in-depth examination of an organization whose corporate structure changed in response to mandated changes in corporate governance. The results provide evidence that corporate governance legislation can potentially induce incumbent management to voluntarily compete in the market for ownership, notwithstanding the associated exposure in the market for managerial control.

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## Introduction

In the face of growing corporate scandals and corporate failures on a global basis, governments and regulatory bodies are increasingly weighing corporate governance legislation and other regulatory standards to help alleviate similar problems in the future. For instance, in the United States (U.S.) the failures of Enron and WorldCom fueled new corporate governance requirements under the mandates of the Sarbanes-Oxley Act of 2002 (SOX). In Australia, similar failures like HIH and OneTel led to the passage of Corporate Law Economic Reform Program, review number 9 (CLERP 9) with its new corporate governance requirements. In Europe, a similar reaction evolved from the Parmalat and Cirio scandals with a number of regulations and directives—most notably the Transparency Directive, the Market Abuse Directive, and the Prospectus Directive (Ivaschenko and Brooks 2008).

All of these efforts to legislate corporate governance policies made under the auspices of the public interest have altered the relationship between shareholders and management (Canada et al. 2008). In

many cases, the regulations have altered firm's business models; and, particularly in the U.S., there have been concerns raised regarding the impact of SOX mandates on global competitiveness (Arnold et al. 2007; Katz 2006; Reason 2006). A number of companies have indicated an interest in not being traded on the various stock exchanges rather than be subjected to the corporate governance requirements articulated under this new legislation. Research confirms the presence of a number of related concerns that appear to have led to a significant increase in delisting activity on U.S. exchanges (Graham et al 2005; Leuz et al. 2008). The evidence suggests that new corporate governance regulation is altering company ownership decisions.

The purpose of this study is to examine how a company's decision to shift corporate ownership and/or corporate control in the face of new corporate governance legislation and regulatory requirements can alter the traditional markets for ownership and control. The research reported in this study focuses on the SOX legislation in the U.S. and its impact on corporate ownership and corporate control.

Within the U.S. stock exchange environment, publicly traded firms wishing to delist their stock can

either *go-dark* or *go-private*. Firms that *go-dark* can continue to trade in over-the-counter markets, but to qualify, they must (1) have less than 300 shareholders at the current time, or (2) have had less than 500 shareholders and less than \$10 million in assets for each of the prior three years. Firms that meet either of these criteria can delist without changing their current ownership, management team, or corporate governance structure. However, for larger firms, *going-dark* is not an option; these firms must *go-private* if they wish to delist, meaning the company's shareholders forego their ownership interest in a broad sale of ownership to a private individual or a private group of owners.

Much of the prior research that has examined factors impacting public to private transactions (PTP) as well as more general corporate ownership change transactions employs a market for corporate control perspective, where management teams compete to gain managerial control of a firm (Fama 1980; Jensen and Ruback 1983; Robbie and Wright 1995; Weir et al. 2005; Leuz 2008). The market for corporate control incents incumbent management to maximize shareholder value as a means of securing their (incumbent managers) control rights and serves as an external corporate governance disciplinary mechanism for poorly performing management or self interested management (Walsh and Kosnik, 1993). However, the market for corporate control models prevalent in the extant literature do not explicitly distinguish between competition for ownership and competition for managerial control. For example, management buy-out decisions (competition for ownership) are viewed as a defensive measure to forestall hostile takeovers (i.e. competition for managerial control) (Jensen and Ruback 1983). However, not all management buy-out decisions are a function of competition for managerial control as some may be in response to new corporate governance regulations; thus corporate governance regulation arguably influences ownership transfer decisions. Analysis of the impact of new corporate governance regulations necessitates adopting a broader view that considers the interplay between the market for managerial control (where incumbent and potential management teams compete for managerial control) and the market for ownership (where incumbent and potential owners compete for ownership rights).

The theoretical contribution of this paper lies in distinguishing a market for ownership and its impact on the market for managerial control. By disentangling the market for ownership from the market for corporate control (i.e. separately considering the market for ownership and the market for managerial control), we provide a general typology for predicting the type of organizational restructuring. This typology incorporates the differential impact of various factors that prior research has shown to impact these markets. Using an in-depth case study, we explore how SOX has

changed the competitive landscape within the market for ownership. The results provide evidence that SOX can potentially induce incumbent management to voluntarily compete in the market for ownership, notwithstanding the associated exposure in the market for managerial control.

The remainder of this paper is presented as follows. The following section reviews prior research that informs the markets for managerial control and ownership, as well as provides the theoretical development for the overall research typology. The third section reports the findings of the case study within the framing of the research typology. The fourth and final section summarizes the findings and discusses the implications for future research.

## Literature Review

Corporate governance structures are presumably designed to align managerial interests with those of the owners through corporate control (Jensen and Meckling, 1976; Fama and Jensen, 1983). These governance structures may be either internal (i.e. composition of the board of directors, type of ownership and incentives) or external (i.e. the market for corporate governance). However, just as there is a market for managerial control, there is also a market for ownership (e.g. initial public offerings (IPOs), management buy-outs, management buy-ins) (Robbie and Wright 1995). The interaction between the market for corporate ownership and the market for managerial control dictates the degree of organizational restructuring that occurs with shifts in either control or ownership (Figure 1).

**[Insert Figure 1 about here]**

### *The Market for Managerial Control*

The market for managerial control is often described as the market where management teams compete for control of firm resources (Jensen and Ruback, 1983). The managerial competition model shown in Figure 1 suggests that the more competitive the market for managerial control the more likely a change in management will occur. For example, owners will consider alternative management teams more attractive when current management is underperforming or acting too self-interested (i.e. a mis-alignment between management and owners as depicted in Figure 2). This same rationale has been used by corporate raiders as a justification for hostile takeovers (Walsh and Kosnik 1993). Hostile takeovers involve unwanted changes in ownership; however, the market for managerial control does not require a change in ownership to achieve a change in management, as current owners may replace incumbent managers just as easily as new owners. When the market for managerial control is less competitive due to barriers to entry (e.g. substantial managerial ownership), effecting management change becomes more difficult.

[Insert Figure 2 about here]

### ***The Market for Ownership***

Just as owners can shop for new management, management can shop for new owners. The more competitive the market for ownership the more likely such a change in ownership will occur. For example, large blocks of family stock ownership weaken the market and make ownership change less likely, while large blocks of institutional stock ownership make the market more competitive and ownership change more likely. This relationship is depicted in Figure 2. A change in ownership is generally effected in one of three ways, incumbent management purchases the firm (management buy-out), a new management team purchases the firm (management buy-in) through a hostile take-over, or a synergistic merger occurs where the acquiring firm retains incumbent management (Robbie and Wright 1995; Jensen and Ruback, 1983; Walsh and Kosnik 1993; Weir 1997). Management buy-outs represent an effort on the part of incumbent management to use ownership as a means of neutralizing competition in the market for managerial control (Weir et al, 2005, Jensen and Ruback, 1983). Management buy-outs are not always easily accomplished, though, as announcements of management's intention to take a company private may trigger competing bids from outside interests. Announcements of potential management buy-ins or synergistic mergers may similarly trigger competing bids. Thus any signaling of an increase in the market for ownership can escalate competition in the market managerial control through an increased pool of prospective owners (Weir et al. 2005; Schwert 2000).

To broaden the understanding of the interaction between the markets for managerial control and ownership, it is necessary to consider factors that can impact the relative competitive strength of these markets. Extant research suggests that company performance, owner/management misalignment, ownership structure, board independence, free cash-flow, and growth potential are factors that differentially affect the markets for managerial control and ownership (Jensen and Ruback, 1983; Weir et al, 2005). Using two lenses, the market for managerial control and the market for ownership, can broaden the understanding of how these various factors impact takeovers, buyouts, public to private transactions, and other forms of organizational restructuring.

### ***Company Performance***

The market for managerial control plays a role in the disciplining of poor managers (Walsh and Kosnik, 1993). Poor performance weakens management's position in the market for control as well as the shareholders' position in the market for ownership. The impact of performance on the market for managerial control is easily established. Poor performance conflicts with the maximization of shareholder wealth and provides owners with a significant motive to find new management. Conversely, strong performance incents current

owners as well as any potential new owners to retain the skills and expertise of the incumbent management team, thus, weakening competition in the market for managerial control (shown in Figure 2).

Company performance and stock price are closely correlated. Poor performance reduces both the stock price and the cost of taking over ownership of the firm, while also reducing the wealth of the existing owner and their ability to fend off hostile bids. As prices reflect poor performance and potential owners believe performance can improve, the firm becomes attractive, which increases competition in the market for ownership. Strong performance, on the other hand, weakens competition in the market for ownership as stock prices reflect firm value.

### ***Owner/Manager Misalignment***

As shown in Figure 2, misalignment between managers and owners increases competition for both managerial control and ownership. When conflicts of interest become apparent, owners look for new managers while management may seek new owners. This type of misalignment often leads to a change in management, ownership, or both. Examples can be found in Bruining et al (2004), where strategic disagreements between a parent company and its subsidiary led to a management buyout, and in Virany and Tushman (1986), where the owners desiring new strategies brought in new top management to provide that new strategy. Strategic disagreements create competition in both the managerial control and ownership markets.

### ***Ownership Structure***

Large blocks of ownership improve the market position of the owners who possess them. With *Family Ownership*, large blocks of family ownership will increase owners' ability to oppose acquisition attempts; and, the commensurate desire by such owners to retain control of a family business can further tighten control and fend off ownership competitors. Thus, family ownership of large blocks of stock is inversely related to competition in the market for ownership (Figure 2), which is consistent with Davis and Stout's (1992) finding that family ownership is inversely related to acquisition.

As shown in Figure 2, with *Managerial Ownership*, large blocks of managerial owned stock improves the position of managing owners while weakening the position of outside owners in the market for ownership. Accordingly, inside ownership can escalate the competition for ownership by increasing the probability of management buyouts (Weir et al, 2005). Inside ownership also improves management's position in the market for managerial control reducing the risk that owners will make decisions that are deleterious to management.

With *Institutional Ownership*, institutional owners invariably choose the highest offer; and, abnormal returns are consistently associated with acquisitions and mergers (Jensen and Ruback, 1983). Accordingly, large blocks of institutional ownership are associated with a higher probability of acquisition

(Shivdasani, 1993), thereby escalating competition within the market for ownership.

#### **Board Independence**

The primary purpose of the board of directors is to align the performance of senior management with owners' interests (Fama, 1980). Independent directors reduce information asymmetry and improve the position of outside owners, while boards that are controlled by insiders are far more likely to serve the interests of management as opposed to shareholders. Independent board chairs and directors are also found to decrease hostile takeovers and management buyouts (Weir 1997; Luez et al., 2008). Thus, independent directors reduce competition within the market for ownership, while simultaneously escalating competition within the market for managerial control, also shown in Figure 2.

#### **Growth Potential**

The literature has consistently found that growth potential is inversely related to changes in ownership (Weir et al., 2005; Coles, 2008; Luez, 2008), suggesting that poor growth potential increases the competition in the market for ownership. Why would owners compete to buy a firm with low growth or future prospects? Weir et al. (2005) explains that Tobin's Q (their proxy for growth potential) represents the growth potential as perceived by the market and Luez et al. (2008) proxies for growth potential with past asset growth. This is where the growth paradox takes hold. These proxies are strong indicators of the growth potential perceived by the market, but neither of these proxies represents the growth potential as perceived by the buyer. If potential buyers believe that the market is undervaluing a firm's growth potential, the result is the creation of a desirable buy situation and explains the association between low growth variables and ownership changes. As shown in Figure 2, growth potential also indirectly impacts the market for managerial control through the market for ownership. Market perceptions of weak growth potential escalate competition in the market for managerial control as new owners will likely replace incumbent management in an effort to realize the firm's growth potential.

#### **Free Cash Flows**

Free cash flows<sup>153</sup> signal a misalignment between owners and managers interests (Jensen, 1986). Owners would normally prefer that excess cash flows be redistributed to owners in the form of dividends. Managers, on the other hand, have incentives to invest in expansion projects (even at unfavorable discount rates since top management pay usually increases with sales growth (Murphy, 1985)). Thus free cash flows signal a misalignment between owners and management interests which can escalate competition

in the market for managerial control (shown in Figure 2).

Jensen (1986) argues that managers of firms with free cash flow will use it as a hedge against hostile takeovers. To avoid a hostile takeover, management may use free cash flows to pay dividends, thereby reducing the misalignment between owners and management interests, or they may use free cash flows to facilitate a management buy-out (Lehn and Poulsen, 1989). If management announces their intent to take the firm private, there are typically counter bids by other interested purchasers, which then escalates competition in the market for ownership (Weir et al. 2005). There is also anecdotal evidence that managers with inside information on the true value of the firm participate in these leveraged buyouts at seemingly high premiums, only to quickly increase the firm's value beyond that of the buyout premium (Bruining et al. 2004; Lehn and Poulsen 1989).

#### **Corporate Governance Regulation and the Market for Ownership**

Evidence regarding the impact of SOX on ownership is paradoxical. On the one hand, corporate concerns regarding the cost of SOX compliance and its impact on global competitiveness are well documented (Arnold et al. 2007; Katz 2006; Reason 2006; Graham et al. 2005). Consistent with these concerns is evidence suggesting SOX may have caused increased corporate deregistrations (Marosi and Massoud 2007; Leuz et al. 2008) which in turn supports theory that corporate governance regulation can change ownership decisions as shown in Figure 2. However, there is also evidence that foreign firms that cross list on U.S. exchanges (voluntarily incurring SOX related costs) increase firm value (Doidge et al., 2004; Karolyi 2006). Thus, if global competitiveness is a concern for U.S. firms, why would foreign firms voluntarily cross list on U.S. exchanges?

Arnold et al. (2007) find evidence that SOX can negatively impact an organization's supply chain response time. For firms who primarily compete with other domestic U.S. firms, the increased response time should not change the firm's competitive position (i.e. supply chain response time increases across all firms and all supply chains). However, for firms whose major competitors are not subject to the same corporate governance regulation (i.e. in the case of SOX, firms not listed on U.S. exchanges), increased response time can degrade the U.S. listed firm's financial performance. When there is a gap between a firm's actual financial performance and their potential financial performance (e.g. supply chain performance absent SOX), there is an increased likelihood of a change in ownership (i.e. escalating competition in the market for ownership).

#### **Analysis of Competing Market Forces**

This study employed a case methodology to investigate contextual factors that may induce incumbent management to voluntarily compete in the

<sup>153</sup> Jensen (1986) defines free cash flows as those in excess of the cash needed to fund all projects with positive net present value when discounted at the relevant cost of capital.

markets for ownership and managerial control. The organizational restructuring typology presented in the prior section was used to inform the data collection and analysis of case data. This study used a combination of publicly available data and semi-structured interviews. Interviews were conducted with a member of senior management and an independent director.

#### **Overview**

Smith Company<sup>154</sup> was a medium-sized company in an industry where supply chain performance had a direct and significant impact on financial performance. Smith Company was an accelerated filer and, like most companies facing the new corporate government regulations, incurred substantial SOX related start up costs. Smith Company's founder was the CEO, chairman of the board of directors, and the single largest shareholder (approximately 20%). During the 1<sup>st</sup> quarter in the year of the buyout, the CEO proposed a leveraged buy-out of Smith Company, advising the board of directors that he felt SOX compliance was too costly. The board formed a special committee to review the offer and the special committee proceeded to hire an investment banking firm to both review the current offer and to solicit additional offers. Although the initial offer fell apart and was replaced with a management buy-out offer, Smith Company was ultimately sold to the highest bidder, a private equity firm.

#### **Case Results**

The following analysis systematically considers each of the factors in the developed typology for analysis with the intent of understanding the predictive ability of each factor on the markets for managerial control and ownership for Smith Company during the time period immediately following the painful corporate governance regulatory compliance process. Each market is analyzed in isolation and then applied in concert to derive expected outcomes (type of restructuring). Finally, the predicted outcome and actual outcome are compared and analyzed in detail.

#### **Free Cash Flows and the Market for Ownership**

As noted earlier, *free cash flows* represent cash that should be distributed to shareholders, but is retained by management and invested in unprofitable projects. Jensen (1986) explains that *free cash flows* arise when firms reach their optimal size; however, Smith was forced to outsource some of its business due to a lack of resources. Furthermore, using the Weir et al (2005) formula for *free cash flows*, Smith's percentage of *free cash flows* is 1.0%, which is below the 4.56% mean of Weir's non-acquired sample. Although Smith improved its cash position three consecutive years, no dividends were distributed and neither the interviews nor the publicly available data hinted that

shareholders were unhappy with the investment of cash. This suggests that *free cash flows* did not impact Smith's market for ownership.

#### **Ownership Structure and the Market for Ownership**

Large blocks of institutional ownership are often directly associated with acquisitions, but in the case of Smith Company there were not any institutional investors who owned large blocks of shares. In fact, the CEO owned the largest number of shares—increasing the probability of a management buyout. Smith's CEO is also the founder, distinguishing Smith Company as a family owned business. Prior research generally finds that family owned businesses are less likely to sell. The lack of large blocks of institutional ownership combined with substantial managerial/family ownership provides the CEO/founder a distinct advantage in the market for ownership (i.e. reducing competition).

#### **Owner/Manager Mis-alignment and the Market for Ownership**

Smith Company displayed no signs of owner/manager misalignment prior to entering the bidding process. The initial offer by the CEO followed a lackluster quarter in which the stock price dropped dramatically. An analyst following the company estimated the initial offer was undervalued approximately 25%. The initial offer was later withdrawn when financing fell apart and it was replaced with a management buy-out offer that was 5% higher than the initial offer but less than a competing offer acquired from a private equity firm. The board accepted the management buyout offer, but an institutional shareholder and the private equity firm sued Smith Company for ignoring the better offer. The private equity firm won the suit and acquired Smith Company after several additional rounds of bidding. Thus, in this case, competition in the market for ownership contributed to an owner/management mis-alignment that had not previously existed.

#### **Corporate Governance Regulation and the Market for Ownership**

SOX compliance, a requirement for most publicly held firms in the U.S., negatively impacted Smith's supply chain performance and response time. Prior to the CEO's decision to take Smith Company private, senior management had indicated that SOX compliance placed the organization at a distinct competitive disadvantage in the global marketplace. As a result of these challenges, the regulatory environment of SOX enhanced the appeal of private ownership.

#### **Expected Growth and the Market for Ownership**

Smith Company consistently grew with increasing profit margins until the year immediately preceding the acquisition. During the year prior to the acquisition, the prognosis for future performance faltered as Smith endured limited growth in revenue and declines in earnings, profit margins and stock price. Low growth potential increases competition for ownership when potential buyers believe that the growth potential is undervalued. As noted earlier, one

<sup>154</sup> We use Smith Company to refer to our case study company in order to protect the identity of the individuals and organization that voluntarily participated in the study. Anonymity is required under institutional review board agreements in regard to the participating human subjects.

analyst viewed the initial offer for Smith Company as undervaluing the firm by 25% even though the offer placed a 20% premium on the current market price.

***Board Independence and the Market for Ownership***

Two indicators of board independence are well established. First, CEO's that also hold the chairman of the board position pose a significant threat to board independence. Second, a high proportion of executive board members indicates a lack of board independence. There are mixed signals coming out of Smith Company. Smith's CEO also held the board chairman position, weakening the board's independence. However, all other board members were independent, including the existence of a financial expert, providing evidence of a fairly independent board. An independent board should decrease the probability of a successful opportunistic bid and thereby dampen the competition for Smith's ownership.

***Company Performance and the Market for Ownership***

As discussed earlier, although Smith Company's prior performance was strong, with solid growth in sales, earnings and profit margins, the performance in the two quarters preceding the initial offer were relatively weak. This weak financial performance was reflected in poor stock performance, enticing potential bidders to enter the market for ownership.

***Smith Company's Overall Market for Ownership***

Review of the various factors within the typology suggests that Smith Company's market for ownership was competitive, especially during the two quarters preceding the initial offer. The escalated competition for ownership was primarily driven by the market's undervaluation of Smith Company's growth potential, which was associated with the lackluster performance of the prior two quarters. Based on the typology, vulnerability in the market combined with large managerial ownership should prompt a management buyout attempt in an effort to protect managerial control. The fairly independent board was the only defense to this type of expected takeover.

***Independent Board and the Market for Managerial Control***

The discussion on market ownership established that Smith Company's board was fairly independent, which should escalate the competition for managerial control. Smith Company's poor performance, in the two quarters preceding the initial offer, should motivate shareholders to look for better management. However, the CEO's role as chairman of the board indicates some trust in his judgment. A bad quarter or two, given the past performance, should not prompt an active search for new management.

***Owner/Manager Misalignment and the Market for Managerial Control***

Prior to the solicitation of bids for acquisition of the company, there were no signs of owner/management misalignment, thus minimizing competition in the market for managerial control. Indeed, even after competitive bidders were brought into the process,

such bidders were not interested in replacing the senior management team, further minimizing competition in the market for managerial control.

***Strong Company Performance and the Market for Managerial Control***

Smith Company's financial performance was stellar during the previous five years. Even during the two lackluster quarters, Smith Company did not lose money—rather they just underperformed in comparison to analysts' expectations. Accordingly, long-time shareholders had experienced substantial gains in stock price over this robust period. Even with the relatively poor recent performance, shareholders who had owned their stock for the full five year period saw 400% growth in the valuation of their stock. Overall, such performance should generally satisfy owners and solidify management's control.

***Managerial Ownership and the Market for Managerial Control***

By virtue of management's large ownership position in Smith Company, management's interest would be well-represented among the interests of owners. Combined with influence the CEO possessed as the chairman of the board, the CEO's interests were also very well-positioned. Given the CEO was the founder, there was clearly no desire to relinquish control even if there was tremendous monetary gain to be had. This overall influence should dampen much of the competition for managerial control.

***Smith Company's Overall Market for Managerial Control***

Most of the factors in the typology suggest that the competitive pressure for control of Smith Company should be very docile. However, given that Smith Company's market for ownership is highly competitive, this docile position does not necessarily indicate that the market for managerial control is static. Entering the market for ownership directly impacts the likelihood of change in the market for managerial control. Thus, it would not be surprising for Smith Company's management to be at a risk notwithstanding the factors supporting incumbent management's control.

***Predicted Organizational Restructuring***

Given the interacting market forces shown in Figure 1, a highly competitive market for ownership combined with a docile competition in the market for managerial control should result in a change in ownership while management is retained. The most popular form of this type of change is the management buyout. Recall that large managerial ownership, poor growth potential (as perceived by the market), and a non-independent board increase the probability of a management buyout. In this case the board is the x-factor. Almost the entire board is independent, yet there are signs that the CEO may have considerable influence. This suggests a management buyout, but there are other possible acquisitions that could produce a similar type of restructuring. Another firm could acquire Smith Company and keep the current management team.

Smith Company's difficulty with SOX would provide private buyers the ability to offer a higher premium than buyers that have to comply with SOX. Overall, the typology suggests a public to private transaction that would retain management, most likely a management buyout.

#### ***Predicted Outcome versus Actual Outcome***

The typology depicts conditions that are consistent with a management buyout. However, Smith Company was actually acquired by a private equity firm other than the group led by the CEO. With the factors so strongly predicting a management buyout, the resulting private acquisition raises questions as to how Smith Company became an acquisition target. The process that produced this acquisition is complicated and provides a rich environment to discuss the interplay of the market forces. Board independence, managerial ownership, growth potential and regulatory compliance drove the competition for Smith Company's ownership. Strong performance, on the other hand, secured most management positions within the firm as five of the eight senior managers were retained after the acquisition was completed.

After two disappointing quarters for Smith Company, the CEO/founder put together a team of equity investors to purchase Smith Company back. The combination of large managerial ownership and low growth potential spawned this bid. The market appears to have overreacted to the apparent halt in Smith Company's growth. Amidst a spurt of acquisitions in the industry, the CEO became concerned that this undervaluation would make Smith Company a takeover target. Interviews with key members of Smith Company revealed that the CEO was very concerned with retaining control. His response to the threat of takeover was to attempt a management buyout. As the typology suggests, the forces in the market for ownership resulted in a management buyout attempt.

The success of such a buyout is contingent upon the board agreeing to the terms. Non-independent boards suffer from managerial influence and hence may accept a buyout offer that does not maximize shareholder value. Smith Company's board was largely independent and acted independently in setting up a special committee to handle the acquisition bidding process. The special committee proceeded to hire an independent investment firm to analyze the offer. Despite the aura of independence, the CEO's influence as board chairman was apparent when the board approved the CEO's offer and agreed to termination fees. The offer, which was an increase over the CEO's initial offer, gave a 30% premium over the recent trading price, but the trading price was at its lowest point in a year. However, this offer still undervalued the firm by approximately 20%. The competing bidder sued Smith Company alleging that the CEO abused his influence to stifle the competing bid. The courts upheld the competing bidder's case and terminated the acceptance.

Subsequent to the buyout termination, a bidding war commenced. Understanding that going private held strong potential for substantial operating gains as SOX compliance could be avoided, both bids rose dramatically. The private equity firm outbid the CEO led buyout group. On the other hand, no public firm ever entered the bidding process even though mergers and acquisitions were rampant in the industry. The most plausible reason for the absence of a public company bidder is the fact that it was highly unlikely that a public firm could have outbid a private firm in this scenario. Avoiding SOX compliance provided gains to the private bidder that a public bidder could not incorporate into their offer.

After such a conflicting battle for ownership, management turnover would seem inevitable. This expectation of management control changes was further supported by the fact that the private equity bidder owned a competitor company that could also manage Smith Company. However, the private equity firm valued Smith Company's industry expertise and current business relationships. The strong performance of the management team secured management's positions within the firm despite the hostile change in ownership, although the CEO/founder did resign.

#### **Conclusions**

This paper posits a market for ownership that interacts with the market for managerial control. Prior studies on takeovers, management buyouts, and management succession have approached each activity as a single action with conflicting results. For example, Jensen (1986) posits that management buy-outs are a defense mechanism within the market for corporate control, while Weir et al (2005) find that the market for corporate control does not impact public to private ownership restructuring decisions. The current paper argues that private to public restructuring is a function of the market for ownership rather than the market for managerial control. The two market perspective provides an umbrella under which evidence from different research streams can be unified.

The case employed in this study provides some evidence that the typology holds predictive validity. Case archival materials supplemented by interviews provide evidence that the theoretical explanations are valid. Specifically, the case sheds light on the explanation of association of growth potential and ownership changes. Weir et al (2005) support the theory that undervaluation plays a role in this association and calls for evidence to better understand its role. The case analysis explicitly finds that the undervaluation of Smith Company contributed to the competition for its ownership and provides additional contextual explanations for this outcome.

The case study also demonstrated the ability of corporate governance regulation to affect the market for ownership. The proponents of SOX did not intend to provide private equity owners with an advantage in

the market for ownership. Indeed, the passage of SOX was intended to increase the public confidence in the stock market and maintain the flow of investment funds to the market (Canada et al, 2008). An analysis of the available data reveals that no publicly held firms participated in the market for Smith Company's ownership even though the industry was rampant with mergers at the time. The most plausible explanation is that public buyers had to contend with potential SOX avoidance gains as a barrier to entry.

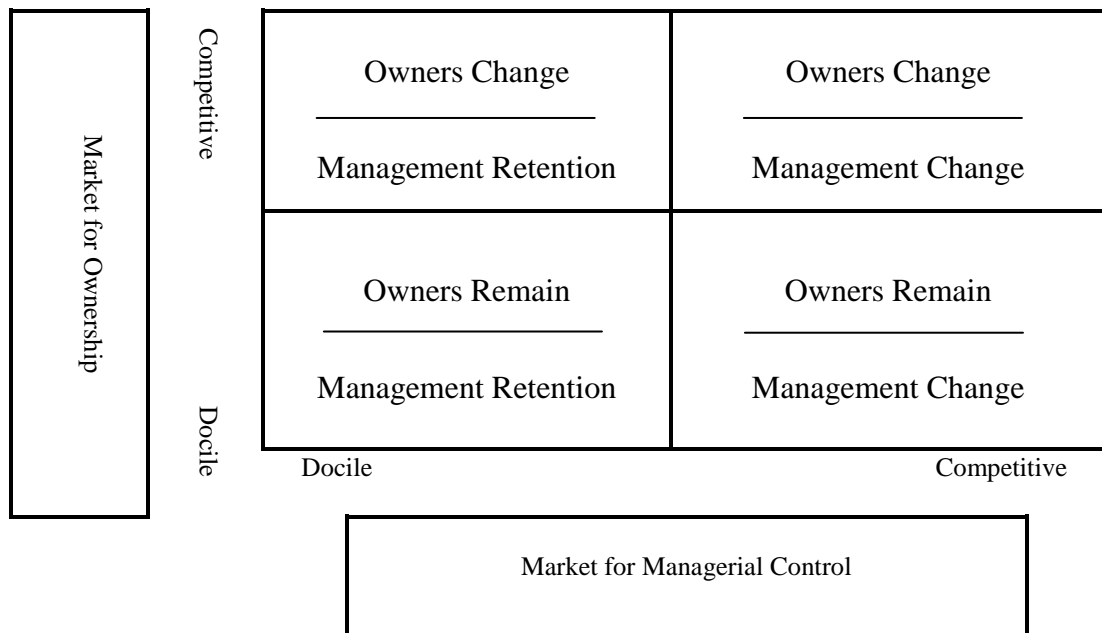
The paper has several limitations. As with all case study research, generalizability is an issue and hindsight is almost always better than foresight. However, the authors strove to be objective, knowing that the outcome of the case could influence the structure of the interviews and evaluation of the case data if the research team was not careful to construct interview questions *a priori* and maintain a somewhat structured approach to the interview based on pre-defined questions. Still, we have a sample of one company and future research should seek to supplement this study utilizing a larger sample of companies as archival data becomes more readily available. Future research should also consider the potential phenomenon that higher premiums are paid when restructuring types differ from those expected based on existing market forces at the time.

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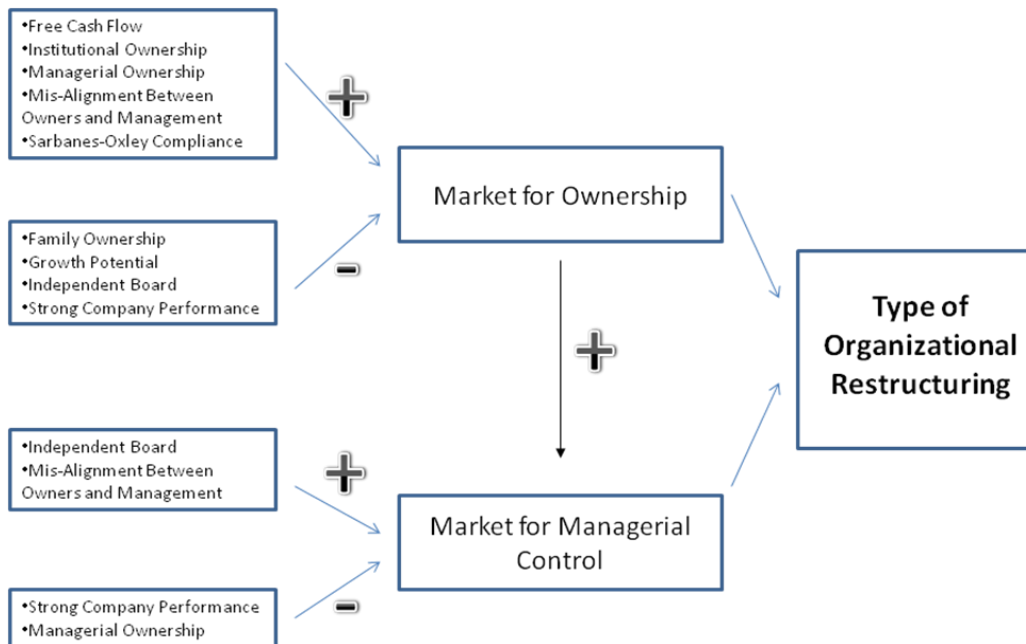
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## Appendices



**Figure 2.** Type of Organizational Restructuring



**Figure 2.** Antecedents of Organizational Restructuring